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The Exemption of Cooperatives From Income Taxation*

By ROSWELL MAGILL†

Periodically there comes a strong wave of sentiment for tax reduction. At the same time, however, citizen demands for federal expenditures for highways, education, airports and other state and local projects, as well as for national defense and foreign aid, have not much abated. Yet it has become a pretty well accepted national policy to balance the budget and thereby to curb inflation.

It follows from all this that federal taxes must remain high for some time to come. The way is not yet open for a substantial reduction in federal revenues. Any revision of the tax system, any reduction in income tax rates causing a loss of revenue will have to be justified by a corresponding increase in revenues from other sources: by broadening the base through the reduction or elimination of existing exemptions or deductions, and by the stimulation of increased business activity and economic growth. This is not an easy road to travel. Every taxpayer enjoys and appreciates tax reduction. By the same token, every taxpayer is automatically opposed to the reduction or elimination of an exemption or a deduction from which he benefits.

In his 1960 budget, President Eisenhower recommended "corrective amendments of the laws on taxation of cooperatives." In January 1959, Secretary of the Treasury Anderson made specific recommendations to Chairman Wilbur D. Mills of the Committee on Ways and Means. Various bills have been introduced relative to the taxation of cooperatives,¹ but no congressional action has been taken and no immediate action seems likely. Yet it is a problem of continuous concern.

What, then, is the present mode of taxation of the income of cooperatives?² Is it satisfactory or should it be revised?

History of the Exemption of Cooperatives

While the first income tax act in 1913 exempted a number of designated organizations from income tax including "labor, agricultural, or horticult-

*This article is based on an address delivered by Mr Magill before the Montana Bar Association Convention at Great Falls, Montana, June 19, 1959. It has also been printed by THE TAX EXECUTIVE and is used here with permission.

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¹See, e.g., H.R. 199, H.R. 3150, H.R. 3848, 86th Cong., 1st Sess. (1959).

²The nature and business of cooperatives; whether they have taxable income; and the income tax treatment of cooperatives are discussed in Magill and Merrill, *The Taxable Income of Cooperatives*, 49 MICH. L. REV. 167 (1950). The present article is essentially a supplement thereto. In its preparation I have been greatly assisted by my associate, Mr. Donald H. Kallman of the New York bar.

tural organizations,"⁸ the specific exemption of cooperatives dates from the 1921 act, which provided an exemption in section 231(11) for:

Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses. . . .

The requirement that the exempt organization be a sales agent was eliminated in section 231(12) of the Revenue Act of 1926. That section provided that exemption should not be denied because the cooperative (1) has capital stock with a fixed dividend not to exceed the greater of 8 per cent or the legal rate of interest in the state of incorporation; (2) has accumulated reasonable tax-free reserves; or (3) buys from or sells to nonmembers, with restrictions on amount. Section 101(12) of the 1939 Code retained the same substance of the 1926 act subsection.

Tax Advantages of Cooperatives Prior to the Revenue Act of 1951

Exempt Cooperatives

Prior to the enactment of the Revenue Act of 1951, farmers' cooperatives that were exempt from federal income tax under section 101(12)⁹ of the 1939 Code enjoyed the following tax advantages by reason of their exempt status:

- (a) Earnings of exempt cooperatives paid to shareholders in the form of dividends on their capital stock were not taxable, but were taxable to nonexempt cooperatives;
- (b) Net margins or profits which were retained as reserves and not allocated to the accounts of patrons were not taxable to exempt cooperatives but were taxable to nonexempt cooperatives;
- (c) Nonoperating income such as interest, dividends, rents,

⁸Revenue Act of 1913, ch. 16, § II G(a), 38 Stat. 172.

⁹The exemption provided by § 101(12) "applies only to farmers' and like associations organized on a cooperative basis which (a) market the products of members or other producers and return to them the proceeds of sales, less necessary marketing expenses, on the basis of the quantity or value of the products furnished, or (b) purchase supplies and equipment for their members or others at cost plus necessary expenses. With respect to both marketing and purchasing associations, the statute requires that there shall be no discrimination between members and nonmembers in returning the net proceeds to patrons in proportion to the produce marketed or supplies purchased. Moreover, the statute specifically provides that the exemption shall be lost if the association markets or purchases more products for nonmembers than it does for members, and purchasing cooperatives lose their exemption if more than 15% of their purchases are for persons who are neither members nor producers. If capital is raised by the sales of stock, substantially all the stock (except nonvoting, nonparticipating preferred stock) must be held by producers, and dividend rights must be limited to no more than 8% or the legal rate of interest in the state of incorporation, whichever is greater." Magill and Merrill, *supra* note 2, at 177-78.

capital gains and income from certain business done with the United States Government and its agencies, was taxable to non-exempt cooperatives even when allocated to the accounts of patrons, but was tax free to an exempt cooperative whether or not allocated.⁵

Nonexempt Cooperatives

As a result of a series of Treasury rulings dating back to 1914,⁶ cooperatives were allowed to exclude from gross income their net margins or profits which had been distributed to members or nonmembers, pursuant to a pre-existing obligation,⁷ in the form of patronage dividends. The exclusion was allowed whether the pre-existing obligation was by charter provision, by-law, or express contract and whether the patronage dividends were distributed to members in the form of cash, stock, revolving fund certificates, certificates of indebtedness, letters or advice, or book credits.⁸ Under these rulings and decisions, a nonexempt cooperative did not need to pay any federal income tax on its operating profits or net margins so long as they were allocated to patrons whether in the form of cash, or in paper certificates of indebtedness, letters of advice, etc.

Patrons of Cooperatives

The tax consequences of receipt of patronage dividends by patrons of a cooperative based on the amount or value of produce furnished to them by the cooperative or the value of supplies or equipment purchased by them from the cooperative was not affected by the status of the cooperative as exempt or nonexempt. Patrons of cooperatives were required to include in their gross income the face amount of any patronage dividends received by them regardless of whether the distribution was made in cash or some form of certificate or paper evidencing the amount of the cooperative's net margins or profits allocated to the patron.⁹ As a practical matter, however, many farmers did not include in gross income patronage dividends paid in noncash forms regardless of Treasury instructions to the contrary.¹⁰

⁵S. REP. No. 781, 82d Cong., 1st Sess. 20-22 (1951).

⁶T.D. 1996 (1914); T.D. 2737 (1918); O.D. 64, 1 CUM. BULL. 208 (1919); I.T. 1499, I-2 CUM. BULL. 189 (1922); I.T. 1566, II-1 CUM. BULL. 85 (1923); S.M. 2288, III-2 CUM. BULL. 233 (1924); S.M. 2595, III-2 CUM. BULL. 238 (1924); A.R.R. 6967, III-1 CUM. BULL. 287 (1924); G.C.M. 12393, XII-2 CUM. BULL. 398 (1933); G.C.M. 17895, 1937-1 CUM. BULL. 56; I.T. 3208, 1938-2 CUM. BULL. 127.

⁷*Farmers' Cooperative Co. v. Birmingham*, 86 F. Supp. 201 (N.D. Iowa 1949); *United Cooperatives, Inc.*, 4 T.C. 93 (1944); *Midland Cooperative Wholesale*, 44 B.T.A. 824 (1941); *Valparaiso Grain & Lumber Co.*, 44 B.T.A. 125 (1941); *Farmers' Union Cooperative Ass'n*, 13 B.T.A. 960 (1928); *Anamosa Farmers Creamery Co.*, 13 B.T.A. 907 (1928); *Home Builders Shipping Ass'n*, 8 B.T.A. 903 (1927); *Albany Creamery Ass'n v. United States*, 51-1 U.S. Tax Cas. ¶ 9256 (D. Ore. 1950); *Colony Farm Cooperative Dairy, Inc.*, 17 T.C. 688 (1951), *acq.*, 1952-1 CUM. BULL. 1; *Dr. P. Phillips Cooperative*, 17 T.C. 1002 (1951); *cf. Beaver Valley Canning Co.*, 9 CCH Tax Ct. Mem. 1120 (1950) (deduction disallowed in absence of pre-existing legal obligation).

⁸All such forms of payment were regarded as the equivalent of cash distributions in the hands of patrons, the theory being that they were cash payments automatically reinvested under the provisions of the charter, bylaws, or other contracts previously agreed to by the patrons. See *United Cooperatives, Inc.*, 4 T.C. 93 (1944).

⁹I.T. 3208, 1938-2 CUM. BULL. 127. Amounts credited to a patron on the books of a cooperative were held to have represented contributions to the capital of the cooperative and as such were taxable to the patron whether or not certificates were issued.

¹⁰Income Tax Information Release No. 2, April 13, 1950, 5 CCH 1950. STAND. FED. TAX REP. ¶ 6111.

*Effect of the Revenue Act of 1951
on the Taration of Cooperatives*

Section 101(12) of the 1939 Code was redesignated as 101(12)(A) of the 1951 act, which also added a new subsection 101(12)(B). Subsection (B), in effect, eliminated the broad exemption from tax formerly accorded to cooperatives qualifying under section 101(12) by providing that such exempt cooperatives were subject to regular corporation income tax on their net incomes,¹¹ less certain special deductions. These special deductions from gross income, granted by subsection (B) to exempt cooperatives, but not permitted to nonexempt cooperatives (*i.e.*, those not meeting the prerequisites of section 101(12)(A)), were for (1) amounts paid as dividends during the taxable year upon its capital stock and (2) amounts allocated to patrons with respect to its income *not* derived from patronage, whether paid in cash, property, certificates of indebtedness, letters of advice, etc.

In addition, subsection (B) provided that patronage dividends, refunds, and rebates to patrons with respect to their patronage, whether paid in cash, property, certificates of indebtedness, letters of advice, etc., might be excluded from gross income "in the same manner as in the case of a cooperative organization not exempt under subparagraph (A)." This provision seemed to give legislative recognition to the series of Treasury rulings and lower court decisions, cited above, which held that cooperatives could exclude from gross income their net margins or profits allocated to members or nonmembers in the form of patronage dividends pursuant to a pre-existing obligation.

The Senate Finance Committee Report states the result as follows:¹²

Section 314 of your committee's bill continues the exemption provided by section 101 (12) of the code but removes from its application earnings which are placed in reserves or surplus and not allocated or credited to the accounts of patrons. In addition to being tax-free with respect to patronage dividends paid or allocated to patrons, as is generally also true in the case of other cooperatives, the cooperatives coming under section 101 (12) are also to remain exempt with respect to amounts paid as dividends on capital stock, and with respect to amounts allocated to patrons where the income involved was not derived from patronage, as for example in the case of interest or rental income, and income derived from business done with the Federal Government. Moreover, they will not be taxed in any way with respect to reserves set aside for any necessary purpose, or reserves required by State law, if such reserves are allocated to patrons.

The purpose of Congress in making this change was stated by the committee as follows:

"As a result of this action, all earnings or net margins of coopera-

¹¹Section 101(12)(B) provided in part as follows: "(B) An organization exempt from taxation under the provisions of subparagraph (A) shall be subject to the taxes imposed by sections 13 and 15, or section 117(c)(1), except that in computing the net income of such an organization there shall be allowed as deductions from gross income (in addition to other deductions allowable under section 23)"

¹²S. Rep. No. 781, 82d Cong., 1st Sess. 21 (1951).

tives will be taxable either to the cooperative, its patrons or its stockholders with the exception of amounts which are paid or allocated to patrons on the basis of purchases of personal, rather than business, expense items.

To summarize, the amendment of section 101(12), effected by the Revenue Act of 1951, was evidently intended to provide for the taxation of all the net margins or profits of an exempt cooperative either to the cooperative itself or to the patron.¹⁸ Previously, an exempt cooperative's "reasonable reserves" were not subject to federal income tax in the hands of the cooperative or its patrons. The taxation of retained earnings not allocated or apportioned by an exempt cooperative was the most important aspect of the 1951 legislative changes.

*Taxation of Cooperatives Following the
Enactment of the Revenue Act of 1951*

Following the enactment of the Revenue Act of 1951, the expressed congressional desire to provide for the taxation of the net margins of cooperatives either to the cooperative or to the patron was realized when patronage dividends were paid in cash. All cooperatives were allowed to deduct cash distributions from income. The cash patronage dividend was income to the recipient. A difficulty arose, however, when patronage dividends were paid in the form of letters of advice, credit memoranda, etc. In view of its long-standing practice of allowing cooperatives to exclude noncash patronage dividends from income, the Treasury attempted to impose a tax on such paper allocations at the patron level.

The basic problem concerning these paper patronage dividends was whether they possessed any market value which could be taxed as income to the recipient patron. For a number of years the Treasury contended that the face amount of the paper distributed should be included in the gross income of the patron. On the other hand, patrons contended that they were only subject to tax on the fair market value of the paper distributed to them. Since, in many cases, the paper did not bear interest and was payable in cash only at the discretion of the cooperative's board of directors, it had no market value. Therefore, the patron was quite correct in asserting that such a paper distribution was not income to him.

The cooperative was able nevertheless to deduct from its gross income the face amount of paper distributions paid pursuant to pre-existing contractual obligations. As a result, Congress' expressed intention that at least a single tax should be payable on a cooperative's net margins was frustrated.

The first cases in this area to come to the Tax Court were those which the Treasury was most apt to win, involving accrual-basis taxpayers. In

¹⁸In order to insure greater compliance by patrons in reporting patronage dividends paid other than in cash, § 148(f) was added to the law. Revenue Act of 1951, ch. 521, § 314(c), 65 Stat. 492. This section required cooperatives to report to the Commissioner the amount and payee of all patronage dividends of \$100 or more paid or allocated during a year. It also authorized the Secretary of the Treasury to require cooperatives to report all patronage dividends.

*Harbor Plywood Corporation v. Commissioner*¹⁴ the petitioner, a corporation reporting its income on the accrual basis, was a patron of a marketing cooperative whose bylaws required it, at the close of each year, to return or credit its net margins to the account of its members. The cooperative issued a credit memorandum to the petitioner representing its share of such net margin. Petitioner excluded the face amount of the credit memorandum from gross income. The Tax Court held that since petitioner was on the accrual basis the face amount of the credit memorandum accrued to it at the time it was credited and should be taxed accordingly.

Until the decision of the Fourth Circuit in *Long Poultry Farms, Inc. v. Commissioner*,¹⁵ the *Harbor Plywood* decision seemed to establish the proposition that cooperative patrons on the accrual basis were required to include in gross income the face amount of paper patronage dividends paid to them by a cooperative pursuant to a pre-existing obligation to declare patronage dividends. In the *Long Poultry Farms* case, however, the Fourth Circuit held that a letter of advice to a patron of the cooperative, who was on the accrual basis, stating the amount of the patronage refund credit which was entered to the credit of the account of the patron but which was payable only at the cooperative's discretion and which was subject to reduction by future losses, was *not* taxable income to the accrual-basis petitioner in the year of allocation.

In the case of cash-basis recipients, the courts have consistently held in spite of the vigorous opposition of the Treasury that noncash dividends are not includible at face value in computing gross income.¹⁶

Thus, a noncash dividend was excludible from the income of an exempt cooperative by section 101(12)(B) and from the income of a nonexempt cooperative under Treasury rules and lower court decisions. The recipient was required to include in his gross income only cash distributions or the fair market value of paper allocations. Since the paper distributions of cooperatives usually had no fair market value, the income represented thereby escaped taxation entirely. In this manner the expressed intent of Congress in enacting section 101(12)(B) was frustrated. No income tax was

¹⁴14 T.C. 158 (1950), *aff'd*, 187 F.2d 734 (9th Cir. 1951). See, similarly, *George Bradshaw*, 14 T.C. 162 (1950), *acq.*, 1950-1 CUM. BULL. 1 (Patron was a member of a partnership which reported its income on the accrual basis. Interest-bearing notes issued to the patron were held taxable to him.)

¹⁵249 F.2d 726 (4th Cir. 1957), *reversing* 27 T.C. 895 (1957).

¹⁶P. Phillips, 17 T.C. 1027 (1951) (patronage dividends represented by certificates voluntarily issued by cooperative held not income to recipient because they had no fair market value); *Estate of Wallace Caswell*, 17 T.C. 1190 (1952), *rev'd*, 211 F.2d 693 (9th Cir. 1954) (Tax Court decision that transferable, interest-bearing certificates which were customarily redeemed in five years were income was reversed on the ground that the certificates were mere evidence of contingent rights in a fund); *William A. Joplin, Jr.*, 17 T.C. 1526 (1952), *acq. as to result only*, 1954-2 CUM. BULL. 4 (preferred stock held taxable to recipient at fair market value, which was found to be face value; book credits held not taxable to recipient); *B. A. Carpenter*, 20 T.C. 603 (1953), *aff'd*, 219 F.2d 635 (5th Cir. 1955) (certificates which had no fair market value held not taxable to recipient); *Mary Grace Howey*, 13 CCH Tax Ct. Mem. 399 (1954) (followed *Carpenter* case in holding certificates were not income to the recipient because they had no fair market value); *Moe v. Earle*, 55-1 U.S. Tax Cas. ¶ 9180 (D. Ore. 1954), *aff'd*, 226 F.2d 583 (9th Cir. 1955), *cert. denied*, 350 U.S. 1013 (1956) (certificates held not income to patron in year of receipt).

collectible in cases in which a cooperative distributed letters of advice or certificates of interest to its patrons pursuant to a pre-existing obligation when such certificates were payable only at the uncontrolled discretion of the cooperative.

Taxation of Cooperatives under the Revenue Act of 1954

Section 101(12)(A) and (B) of the 1939 Code were enacted without any substantive changes as sections 521 and 522 of the 1954 Code.¹⁷ Therefore, the statutory scheme for the taxation of cooperatives developed in the Revenue Act of 1951 still remains in effect.

The Treasury Department published final regulations on the taxation of patrons of cooperatives receiving patronage dividends on November 25, 1957,¹⁸ restating the position it had maintained prior to the adverse *Long Poultry Farms* decision and other decisions cited above. Section 1.61-5 of such regulations provides in part as follows:

Allocations by cooperative associations; tax treatment as at patrons. (a) *In general.* Amounts allocated to the basis of the business done with or for a patron by a cooperative association, whether or not entitled to tax treatment under section 522, in cash, merchandise, capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice or in some other manner disclosing to the patron the dollar amount allocated, shall be included in the computation of the gross income of such patron for the taxable year in which received to the extent prescribed in paragraph (b) of this section. . . . The determination of the extent of taxability of such amounts is in no way dependent upon the method of accounting employed by the patron or upon the method, cash, accrual, or otherwise, upon which the taxable income of such patron is computed.

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association . . . shall be included in the computation of the gross income to such patron to the following extent:

(i) If the allocation is in cash, in the amount of cash received.

(ii) If the allocation is in merchandise, to the extent of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, certificates of indebtedness, letters of advice, retain certificates, or similar documents—

(a) To the extent of the face amount of such documents, if the allocation was made in fulfillment and satisfaction of a valid obligation of such association to the patron, which obligation was in existence prior to the receipt by the cooperative association of the amount allocated.

* * * *

(c) To the extent of the cash or merchandise received in redemption or satisfaction of such documents (except those which are negotiable instruments) at the time of receipt of such cash or merchandise by the patron, where such allocation was not made in pursuance of the valid obligation referred to in (a) of this subdivision. . . .

On March 11, 1959, however, the Treasury Department published proposed amendments to regulation 1.61-5, set forth above.¹⁹ These new regulations were proposed in order to bring existing regulations into conformity with the decisions of the Fourth Circuit in *Long Poultry Farms, Inc. v. Commissioner*,²⁰ and the Fifth Circuit in *B. A. Carpenter v. Commissioner*,²¹ and provide in part as follows:

§ 1.61-5 Allocations by cooperative associations; tax treatment as to patrons.—

* * * *

(b) *Extent of taxability.* (1) Amounts allocated to a patron on a patronage basis by a cooperative association with respect to products marketed for such patron, or with respect to supplies, equipment, or services, the cost of which was deductible by the patron under section 162 or section 212, shall be included in the computation of the gross income of such patron, as ordinary income, to the following extent:

(i) If the allocation is in cash, the amount of cash received.

(ii) If the allocation is in merchandise, the amount of the fair market value of such merchandise at the time of receipt by the patron.

(iii) If the allocation is in the form of capital stock, revolving fund certificates, retain certificates, certificates of indebtedness, letters of advice, or similar documents, the amount of the fair market value of such document at the time of its receipt by the patron. For the purposes of this subdivision, capital stock and any document containing an unconditional promise to pay a fixed sum of money on demand or at a fixed or determinable time shall be considered to have a fair market value at the time of its receipt by the patron. However, any revolving fund certificate, retain certificate, letter of advice, or similar document, which is payable only in the discretion of the cooperative association, or which is otherwise subject to conditions beyond the control of the patron, shall be considered not to have any fair market value at the time of its receipt by the patron.

(2) If any allocation to which subparagraph (1) of this paragraph applies is received in the form of a document of the type described in subparagraph (1)(iii) of this paragraph and is

¹⁹A public hearing on the proposed regulations was held on May 6, 1959. The report of those hearings contained in the Daily Report for Executives of May 7, 1959, indicated that most of the interested parties testifying were of the view that the issuance of any regulations in this area should be postponed until congressional action on legislation to change the present method of taxing cooperatives is taken.

²⁰*Supra* note 15.

²¹219 F.2d 635 (5th Cir. 1955).

redeemed in full or in part or is otherwise disposed of, there shall be included in the computation of the gross income of the patron, as ordinary income, in the year of redemption or other disposition, the excess of the amount realized on the redemption or other disposition over the amount previously included in the computation of gross income under such subparagraph.

These proposed Treasury regulations make it clear that a patron of a cooperative, whether on the cash or on the accrual basis, need not include in his gross income revolving fund certificates, letters of advice or similar documents received from the cooperative as patronage dividends and which are payable only in the cooperative's discretion, or which are otherwise subject to conditions beyond the control of the patron. Therefore, through the use of patronage dividends in the form of letters of advice, etc., payable at the discretion of the cooperative, it is possible for a cooperative and its patrons to avoid completely any federal income tax on the cooperative's allocated net margins.

Recent Legislative Developments

The failure of the statutory framework added to the law by the Revenue Act of 1951, and re-enacted as sections 521 and 522 of the 1954 Code, to provide at least a single federal income tax either on the cooperative or on its patrons on the cooperative's allocated net margins has resulted in demands for remedial legislation. Secretary of the Treasury Anderson, in a letter dated January 19, 1959, to Wilbur D. Mills, Chairman of the Ways and Means Committee of the House of Representatives, outlined the problem as follows:

In testimony before your Committee on January 16, 1958, I pointed out that the proper taxation of cooperatives continues to be a troublesome problem. As you know, a series of court decisions have made largely ineffective the 1951 legislation which was intended to assure that all cooperative income was to be taxed either to the cooperative or to its members as it was earned. Treasury rulings under which all patronage refunds in the form of certificates were held to be taxable at the face value have been held invalid where the certificates do not have a determinable market value. Thus, it is possible for the cooperative to receive a deduction in computing its taxable income while its members are not taxable on the certificates they receive.

As I stated in my testimony, while we are fully aware of the important place which cooperatives occupy in the life of our agricultural and farming communities, we believe that, as was contemplated in the 1951 legislation, some single tax liability should be assumed by all who participate in the business activities of the country and that legislation should be developed which imposes such a tax and at the same time is fair and reasonable from the standpoint of the members and the relative availability of retained earnings for expansion.

We suggest that your Committee consider a method of taxation under which the tax-free retention of income would be limited to three years. Under this method cooperatives would be permitted to deduct amounts paid to the patron during the taxable year if

paid (1) in cash or (2) in the form of "qualified" patronage certificates. A qualified certificate must bear interest at the rate of at least four percent, must by its terms be redeemable in cash within three years after the close of the year in which issued, and must in fact be redeemed in cash within the three-year period. The cooperative would not be permitted a deduction in respect of non-qualified certificates, such as certificates redeemable within a period in excess of three years or bearing interest at a rate of less than four percent, until the document is redeemed in cash.

The patron would be required to include in his income only the cash amounts received, either as current cash distributions or on redemption of qualified or non-qualified certificates.

Thus, all distributions of cash, including redemptions of non-qualified documents, would be deductible by the cooperative and taxable to the patron. In order to insure that the single tax is collected at ordinary income tax rates, it would be necessary to treat amounts received upon redemption and upon the sale or exchange of redeemable certificates as ordinary income rather than capital gain.

You may wish to consider other methods of achieving a single tax liability for cooperative income. A number of alternative methods have been suggested and we shall be glad to weigh and consider the merits of these various proposals during the course of the deliberations of your committee. In connection with the selection and development of legislation that is reasonable and fair, the staff of the Treasury will continue to work cooperatively with the staff of your committee.

Secretary Anderson submitted a proposed draft of new tax legislation to the Speaker of the House of Representatives on January 29, 1959. The Secretary summarized his draft as one which

... would insure the ultimate payment of a single tax on cooperative income. It limits the tax-free retention of income by a cooperative to a period of three years. This is accomplished by permitting a cooperative to deduct amounts paid to its patrons during the taxable year if paid (1) in cash or (2) in the form of "qualified" patronage certificates, that is, certificates which bear interest at the rate of at least 4% and which are redeemable in cash within three years after the close of the year in which issued. The patrons would be required to include in their income only the cash amounts received, either as current cash distributions or on redemption of certificates.

Although several bills relative to the taxation of cooperatives have been introduced in the House, action at the present session appears unlikely.

Proposed Revisions of the Exemption

Thus we arrive at the main question: Is there any occasion for change in the exemption of cooperatives? The President and the Secretary of the Treasury seem to think that there is need for "corrective amendments." The Congress is apparently reluctant to act.

The principal proposition upon which any general revision of the in-

come tax law will be based is that incomes from whatever source should be taxed; and exemptions should be granted only if they are clearly in the public interest. Thus, the income of a private school or college may be exempt, but if the school is operated for private profit, it will not be.

Cooperatives originally were small organizations, which could be regarded as agencies for farmers in buying for them or selling their produce. Many cooperatives have now become great, largely through the retention of untaxed earnings, well able to compete effectively with other business corporations. Cooperatives actually do so compete most effectively. The present-day cooperative is not technically an agent for the sale, purchase, or manufacture of products for the members, for the patron has no right to control the sale, fix the price and terms, recall the goods, or to demand and receive the proceeds when sold. The patron's position in relation to the cooperative initially is that of a customer who buys or sells at current market prices. Thereafter, his position as to actual or potential distributions resembles that of a small stockholder to an ordinary business corporation. The methods of operation and expansion of the cooperative's business and the accumulation or distribution of its earnings are controlled by directors, not by patrons. The directors exercise a discretion far removed from the limited authority of an agent.

The next question is, aside from a statutory exemption: Is a cooperative entitled to buy products from its patrons or sell to them at current market prices; realize gains from its operations during the year; and then, by distributing to the patrons cash, or evidence of a remote interest in such gains, avoid earning taxable income? If its neighboring competitor, an ordinary partnership or private corporation, does exactly the same thing, but makes its distributions or accountings to partners or stockholders, it will certainly be held to have realized taxable income. I do not believe that it can fairly be held that the cooperative has not realized income in a like situation. Cooperatives are and have been operated for profits—very large profits. In an equitable sense, those profits belong to the patrons, but only in the sense that a business corporation's profits belong to its shareholders. The corporation, whether business or cooperative, first realizes the profits for itself, and then decides whether to retain them for expansion or to distribute them.

If you agree with this analysis, your conclusion must be that the current exemption in the statute is unjustifiable; in particular, that a cooperative should be taxed on its income, whether or not it issues to its patrons certificates evidencing net margins in some amount, such certificates being only payable in the discretion of directors at some wholly indefinite time in the future.

By virtue of the present deduction for distributed income, a cooperative corporation is enabled to reduce its taxable income to an amount materially less than the taxable income of any other business corporation, for the latter is granted no similar deduction for distributions of income. Moreover, the deduction is allowable whether or not the distribution of the net income of the cooperative corporation is made in cash, notes, certificates or merely in credits to patrons on the books of the cooperative corporation. Thus, cooperative corporations are enabled to escape the income tax entirely by

the issuance of some form of paper certificates to patrons, redeemable at the discretion of the directors of the cooperative corporation. To be sure, cooperatives are required to file information returns, in which all patronage dividends in excess of \$100 are required to be reported. In the light of the substantive provisions of the law, however, the information return provision has required merely that the Internal Revenue Service be informed of paper distributions that, in fact, it cannot tax.

Congress demonstrated its intent to tax the entire net income of cooperatives in 1951. The approach of taxing part of the income to the cooperative corporation and part to the patron has proved unworkable. The fair and effective way of achieving the congressional intent is to levy the tax on the cooperative corporation on its entire net income, with no exclusion or deduction for patronage dividends regardless of their form.

The taxation of the entire net income of cooperative corporations is justifiable on various grounds. In the first place, income realized by cooperative corporations should in fairness be taxed on the same basis as the income realized by other competing corporations. There seems to be no good reason for making a tax distinction between cooperative corporations actively engaged in business and other kinds of corporations competing actively with them. Each is a legal entity engaged in an enterprise for profit. Consequently, the proposal to tax cooperative corporations upon the portion of their net incomes remaining after a deduction or exclusion from income of patronage dividends paid in cash or in notes possessing a readily determinable market value, while ordinary business corporations remain taxable upon their entire net incomes with no deduction for dividends distributed in cash or its equivalent, is seriously objectionable. The net income realized by a cooperative with no exclusion or deduction for patronage dividends in reality constitutes its income for tax purposes as it does for other purposes. There is no legitimate reason, in my opinion, for discriminating in favor of cooperative corporations and against other business corporations that must compete with them directly.

In the second place, the federal income tax is levied generally on the basis that a corporation is an entity distinct from its shareholders or patrons, and therefore that it should bear a tax upon its own income, whether that income be distributed or not. So long as ordinary business corporations are taxed in this way, cooperative corporations engaged in similar business activities should be taxed in the same way.

The early stages of the forthcoming proposed revision of federal revenue laws will demonstrate whether Congress is really in earnest in its expressed desire to reduce taxes on citizens generally by closing loopholes, eliminating inequities, and generally broadening the base. The exemption of cooperatives is an exemption which crept into the law at a time when income tax rates were low. It was not recognized then that an exemption granted to *A* may very well mean that *B*, *C*, *D* and *E* have to pay more taxes. It is reasonably clear now that the taxes of *B*, *C*, *D* and *E* cannot be reduced, high as they are, unless *A* is required to pay the same tax on its business income that *B*, *C*, *D* and *E* have to pay.

Cooperatives are conspicuous beneficiaries of an exemption which their

competitors do not enjoy. The exemption may have been necessary in the infancy of cooperatives. Now that cooperatives have come of age, it is quite unnecessary to their continued growth and health. The exemption deprives the Treasury of some hundreds of millions of dollars of needed revenue; and gives one form of business organization a wholly unfair competitive advantage over other forms of business organization. In the interests of greater equality of taxation in this country, the exemption from income tax of the income of cooperatives should be abolished.